The Asset Management Industry SERVING INDIVIDUAL INVESTORS

INVESTMENT COMPANY INSTITUTE

COMMENT LETTER

July 26, 2012

ICI Comment Letter on CFTC's Proposed Rules Prohibiting Aggregation of Orders to Satisfy Minimum Block Sizes or Cap Size Requirements (pdf)

July 26, 2012 Mr. David A. Stawick Secretary Commodity Futures Trading Commission Three Lafayette Centre 1155 21st Street, NW Washington, DC 20581 Re: Rules Prohibiting the Aggregation of Orders to Satisfy Minimum Block Sizes or Cap Size Requirements, and Establishing Eligibility Requirements for Parties to Block Trades (RIN 3038- AD84) Dear Mr. Stawick: The Investment Company Institute ("ICI")1 is submitting this letter in response to the re- proposal by the Commodity Futures Trading Commission ("CFTC" or "Commission") to add provisions to part 43 of the CFTC's regulations that would prohibit aggregation of orders for different trading accounts for the minimum block size or cap size requirements except under certain circumstances and would specify the eligible parties to a block trade.2 We generally support the Commission's proposal and exceptions from the prohibition but seek several modifications to the conditions for the exceptions and a clarification regarding the provision on eligible block trade parties. 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.9 trillion and serve over 90 million shareholders. 2 Rules Prohibiting the Aggregation of Orders to Satisfy Minimum Block Sizes or Cap Size Requirements, and Establishing Eligibility Requirements for Parties to Block Trades, RIN 3038-AD84, 77 FR 38229 (June 27, 2012), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-15481a.pdf ("Proposal"). These provisions were inadvertently omitted in the CFTC's re-proposal for determining block trade sizes pursuant to Section 727 of the Dodd-Frank Wall Street Reform and Customer Protection Act ("Dodd-Frank Act"). Procedures to Establish Appropriate Minimum Block Sizes for Large Notional Off-Facility Swaps and Block Trades, 77 FR 15460 (Mar. 15, 2012), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-5950a.pdf. Mr. David A. Stawick July 26, 2012 Page 2 of 6 Aggregation Prohibition and Exceptions The CFTC proposal would prohibit the aggregation of swap orders for different trading accounts to satisfy the minimum block size or cap size requirements except for orders aggregated by certain persons.3 Aggregation would be permissible if done on a designated contract market ("DCM") or swap execution facility ("SEF") by a person who has more than $25

million in total assets under management and is a person who is: (1) a commodity trading advisor (“CTA”) registered pursuant to Section 4n of the Commodity Exchange Act (“Act”) or exempt from such registration under the Act, or a principal thereof, and who has discretionary trading authority or directs client accounts; (2) an investment adviser who has discretionary trading authority or directs client accounts and satisfies the criteria of Rule 4.7(a)(2)(v) under the Act; or (3) a foreign person who performs a similar role or function as the persons described above in (1) or (2) and is subject as such to foreign regulation. To satisfy the criteria under Rule 4.7(a)(2)(v), an investment adviser must be registered pursuant to Section 203 of the Investment Advisers Act of 1940 (“Advisers Act”) or pursuant to the laws of any state, or a principal thereof, and (1) have been registered and active as such for two years or (2) provide securities investment advice to securities accounts which, in the aggregate, have total assets in excess of $5 million deposited at one or more registered securities brokers. We strongly agree with the Commission’s determination that certain persons, including investment advisers, have legitimate reasons for aggregating orders and should be permitted to treat such orders placed as a block trade if the trade satisfies the minimum block size.4 As discussed in our prior letters to the Commission, block trades enable funds (on behalf of their shareholders) to engage in large transactions with minimal disruptions to the swaps market.5 Advisers generally aggregate client orders to minimize transaction costs and information leakage. Therefore, the ability to aggregate provides advisers to these funds the ability to execute large amounts without incurring higher costs that could result if advisers were forced to break up the order into smaller orders, which would create market 3 A block trade has a notional or principal amount at or above the appropriate minimum block size and is reported publicly subject to time delay requirements. A cap size is the maximum notional or principal amount of a publicly reportable swap transaction that is publicly disseminated. A transaction that meets the cap size requirement would be eligible to mask the total size of the transaction if it equals or exceeds the applicable cap size. 4 Similarly, given the lack of depth and liquidity in the swaps market, to prevent the identities, business transactions, and market positions of market participants engaging in large transactions from being revealed, an adviser should be permitted to aggregate orders to satisfy the cap size requirements. 5 See Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated May 14, 2012; Letter from Karrie McMillan, General Counsel, ICI, to David A. Stawick, Secretary, CFTC, dated Feb. 7, 2011. Mr. David A. Stawick July 26, 2012 Page 3 of 6 inefficiencies and potentially diminish liquidity. In addition, opportunistic market participants may piece together information about holdings or the trading strategy of the adviser’s funds, leading to front running. We, therefore, fully agree with the CFTC’s proposal to provide exceptions from the prohibition on aggregation for certain persons who may engage in block trades on behalf of their clients. We have two areas of concerns with the exceptions as proposed, however – one with the general criteria and a second concern specific to the exception for investment advisers. Although we support the goal of the Commission to prohibit aggregation of orders for different accounts to “prevent potential circumvention of exchange-trading and of the real-time reporting obligations associated with non-block transactions,”6 we do not believe several of the conditions of the proposed exceptions are necessary to accomplish that purpose and may unintentionally prevent certain registered investment advisers from taking advantage of the exceptions. First, to qualify for the exceptions, the CFTC proposes to require that the persons have at least $25 million in total assets under management. The Commission does not articulate a rationale for the assets under management criterion, and there appears to be no policy reason to impose this requirement. We believe that, as recognized by the Commission in proposing the exceptions, registered investment advisers regardless of the amount of assets under management have a legitimate purpose for aggregating orders on behalf of their funds and

other clients. Although advisers to registered funds typically would have more than $25 million in total assets under management,7 even advisers with less than the proposed assets have a valid need to engage in block trades on behalf of the funds they manage. The exceptions should not be limited to advisers that manage a certain level of assets because there is no relationship between the amount of assets managed and the legitimacy of aggregating client orders. For these reasons, we also do not believe that the assets under management criterion should be linked to swap assets, be required per asset class, or be different for the five different asset classes of swaps. We recommend the removal of the assets under management criterion and strongly urge the Commission not to impose an assets under management criterion linked to swap assets or to particular swap asset classes. 6 See Proposal, supra note 2, at 38231. 7 Under Section 203A(a) of the Advisers Act, an adviser to a registered investment company (regardless of the amount of assets) and an investment adviser with assets greater than $100 million must register with the Securities and Exchange Commission ("SEC"). Under Section 203A(a)(2) (added by the Dodd-Frank Act), an adviser that has assets under management between $25 million and $100 million must register with the state in which it maintains its principal office and place of business (rather than with the SEC) if it would be subject to examination as an investment adviser by such state authorities. An investment adviser with less than $25 million in assets under management also is required to register with the states rather than the SEC. Mr. David A. Stawick July 26, 2012 Page 4 of 6 Second, for an investment adviser who has discretionary trading authority or directs client accounts, the proposal would require that the adviser satisfy the criteria of Rule 4.7(a)(2)(v). Under this rule, an investment adviser must be registered pursuant to Section 203 of the Advisers Act or pursuant to the laws of any state, or a principal thereof, and (1) have been registered and active as such for two years or (2) provide securities investment advice to securities accounts which, in the aggregate, have total assets in excess of $5 million deposited at one or more registered securities brokers. We question why it would be necessary for an adviser to be registered or active for two years before it is permitted to aggregate client orders for block trades. In addition, we are concerned about the requirement that newly registered investment advisers must provide advice to accounts deposited at one or more registered securities brokers. Registered investment advisers may not be able to satisfy the requirement that the assets be deposited at a securities broker because fund assets are generally held in the custody of a bank. Under the Investment Company Act of 1940 (''ICA''), registered funds are required to custody their assets in accordance with Section 17 of the ICA.8 Nearly all registered funds use a U.S. bank custodian for domestic securities although the ICA permits other limited custodial arrangements.9 Foreign securities are required to be held in the custody of a foreign bank or securities depository. Because registered funds typically use banks as custodians, registered investment advisers to registered funds may not be able to satisfy the second prong of the Rule 4.7(a)(2)(v) criteria. We do not believe that the CFTC intended ''newly'' registered advisers to registered funds to be ineligible for the exemption when their fund assets are custodied at a bank, in compliance with the ICA, rather than a securities broker. There is no policy reason to prohibit advisers that custody fund assets in compliance with the ICA from aggregating orders for block trades. We, therefore, request that the CFTC not reference Rule 4.7 but instead require that the adviser be registered under Section 203 of the Advisers Act or pursuant to any state or a principal thereof without specifying a minimum number of years registered or where the client assets are deposited. Both the ICA and the Advisers Act impose requirements on the custody of fund and other client assets, respectively. We do not believe that it is necessary for the exception from the aggregation provisions to impose custodial requirements separately. 8 The Advisers Act and Rule 206(4)-2 thereunder also govern custody of client assets (other than registered fund

assets). Registered investment advisers must have client funds or securities maintained by a qualified custodian (e.g., regulated banks and registered broker-dealers) and comply with certain other requirements. See Rule 206(4)-2 under the Advisers Act. 9 In addition to Section 17, the ICA contains six separate custody rules for the different types of possible custody arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Mr. David A. Stawick July 26, 2012 Page 5 of 6 Eligible Block Trade Parties and Exceptions The CFTC proposal also would provide that parties to a block trade must qualify as eligible contract participants ("ECPs").10 The proposed rule includes an exception by providing that a DCM may allow certain CTAs, investment advisers and foreign persons to transact block trades for customers who are not ECPs if such CTAs, investment advisers and foreign persons have more than $25 million in total assets under management. The persons eligible for the exception are the same as those proposed to be excepted from the aggregation prohibition. In addition, the proposal would require that persons transacting block trades on behalf of customers must receive prior written instructions or consent from the customer. The instructions or consent may be provided in a power of attorney or similar document by which the customer provides the person with discretionary trading authority or the authority to direct the trading in its account. We request a clarification that only a person transacting a block trade on behalf of a customer who is not an ECP must receive prior written instruction or consent from the customer. We do not believe it is necessary for investment advisers to obtain consent from clients who qualify as an ECP and therefore are eligible to engage in block trades. Moreover, investment advisers with discretionary trading authority already have the ability to aggregate orders on behalf of clients without obtaining a separate consent for such transactions.11 We, therefore, request an amendment to proposed Rule 43.6(i)(2) to add "who are not eligible contract participants" after "customer" to make clear that persons transacting block trades for customers who are ECPs are not required to obtain consent. * * * We appreciate the opportunity to comment on the Commission's proposal. We support the Commission's proposed exceptions from the prohibition on aggregation. If you have any questions on 10 ECPs include, among others, an investment company subject to regulation under the ICA acting for its own account and an investment adviser subject to regulation under the Advisers Act acting as investment manager or fiduciary for certain persons (including a registered fund). See Section 1a(18) of the Act. 11 SEC-registered investment advisers are permitted to aggregate orders for advisory clients, including a registered investment company provided that the investment company participates on terms no less advantageous than those of any other participant. See SMC Capital Inc. (pub. avail. Sept. 5, 1995). In fact, the SEC has stated that "[c]lients engaging an adviser can benefit when the adviser aggregates trades to obtain volume discounts on execution costs." If an adviser does not aggregate trades when it has the opportunity to do so, the adviser must explain, in its registration form filed with the SEC and its brochure delivered to clients, that clients may therefore pay higher brokerage costs. See Amendments to Form ADV, Release IA–3060, 75 FR 49234 at 49244 (Aug. 10, 2010), available at http://www.sec.gov/rules/final/2010/ia-3060fr.pdf. Mr. David A. Stawick July 26, 2012 Page 6 of 6 our comment letter, please feel free to contact me at (202) 326-5835 or Jennifer Choi at (202) 326- 5876. Sincerely, /s/ Sarah A. Bessin Senior Counsel cc: The Honorable Gary Gensler The Honorable Jill E. Sommers The Honorable Bart Chilton The Honorable Scott D. O' Malia The Honorable Mark Wetjen

should not be considered a substitute for, legal advice.